

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:PEN:PHI:TL-N-3629-99

LSBednarz

date:

to: Jack Cohen, Group Manager
Coordinated Examination Branch, Group 1408
King of Prussia, PA Attn: Edward Wirth
Case Coordinator

from: Assistant District Counsel, Group 2
Pennsylvania District

subject:

Request for Legal Advice

THIS DOCUMENT INCLUDES STATEMENTS SUBJECT TO THE ATTORNEY CLIENT PRIVILEGE AND THE ATTORNEY WORK PRODUCT PRIVILEGE. THIS DOCUMENT SHOULD NOT BE DISCLOSED TO ANYONE OUTSIDE THE IRS, INCLUDING THE TAXPAYER INVOLVED. LIMIT USE OF THIS DOCUMENT TO THOSE WITHIN THE SERVICE WORKING ON THIS CASE. THIS DOCUMENT IS SUBJECT TO I.R.C. SECTION 6103.

This is in response to your request for legal advice regarding the following factual situation: You are presently examining the income tax returns for [REDACTED] for the taxable years ended [REDACTED] and [REDACTED]. In the course of your examination, you found that [REDACTED] had entered into certain contracts with a company known as [REDACTED] during the taxable years in issue.

Under the contracts, [REDACTED] agreed to perform several efficiency studies to determine the most efficient and low cost methods [REDACTED] could use to accomplish certain tasks. A total of four contracts were executed during the [REDACTED] through [REDACTED] taxable years, however, the results of two of the studies set forth in the contracts (" [REDACTED] " dated [REDACTED] and " [REDACTED] " dated [REDACTED] were never implemented. The two remaining contracts, under which costs were incurred by [REDACTED] are as follows:

1) "Transportation Agreement" dated [REDACTED]: This contract involved an efficiency study to optimize [REDACTED]'s rail freight, motor carrier freight and barge freight of products to and from its facilities as well as all employee travel. [REDACTED] would recommend certain changes in operations, project cost savings and actually measure cost savings achieved. Under this agreement, [REDACTED] would receive compensation in the amount of [REDACTED] the actual savings achieved after its recommendations were implemented.

2) "Strategic Sourcing Agreement" dated [REDACTED]: This contract involved an examination of the efficiency of the procurement function at [REDACTED] through a study of the suppliers, development of market knowledge, eliminating bureaucracy, etc. The objective was to increase value and reduce total costs associated with purchased materials and supplies and enhance the procurement skills of [REDACTED] personnel.

The total costs incurred by [REDACTED] under these contracts for the [REDACTED] years at issue was approximately \$[REDACTED]. You have asked us whether the fees paid to [REDACTED] must be capitalized, because they produce long-term benefits. The taxpayer takes the position that the costs incurred are currently deductible expenses under Section 162.

Section 162 generally allows the deduction of all ordinary and necessary business expenses incurred during the taxable year. However, expenses are not deductible currently under Section 263 if they are incurred for assets with a useful life lasting beyond one year (permanent improvements) or if they create a benefit that lasts beyond the current tax year. INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992) and Commissioner v. Lincoln Savings & Loan Assn., 403 U.S. 345 (1971). Each case must be judged on its particular facts and circumstances. The question in the present case is whether the costs incurred under the contracts discussed above were for permanent improvements.

The Internal Revenue Service has taken the position, despite the decision in INDOPCO that expenses are currently deductible, even if they produce some future benefits. See Rev. Rul. 92-80, 1992-2 C.B. 57 (advertising expenses); Rev. Rul. 94-12, 1994-1 C.B. 36 (incidental building repairs); Rev. Rul. 94-77, 1994-2 C.B. 19 (severance pay); IRS Letter Ruling 9627002 (environmental cleanup investigation costs) and Rev. Rul. 96-62, 1996-2 C.B. 9 (training costs).

We believe that the type of costs incurred in the instant case should be considered currently deductible. The costs incurred under the transportation contract, primarily help the taxpayer to save on transportation and employee travel expenses, which are currently deductible. Likewise, training costs connected with the strategic sourcing contract reduce expenses related to training and purchases, both of which are currently deductible. Thus, it is our opinion that the costs incurred under these contracts with [REDACTED] are currently deductible as business expenses under Section 162 even though they may have some future benefit. Such costs should be capitalized only where they are expended primarily to obtain future benefits. See Cleveland Electric Illuminating Co. v. United States, 7 Cl. Ct. 220, 227 (1985) where the costs of training employees to operate a new nuclear power plant were capitalized, an analogy being drawn to startup costs of a new business.

Case Coordinator Edward Wirth also sent us a copy of IRS Letter Ruling 9544001, dated November 8, 1995 which dealt with the initiation of an efficiency process known as "JITM". That ruling held that consulting fees paid under the efficiency contract should be capitalized. We believe that the holding in that Letter Ruling can be distinguished because in that case, the taxpayer insisted that it entered into the program to receive long-term future benefits. In the present case, the taxpayer recognizes that current expenses and costs will be reduced although some long-term benefit will result. Thus, we believe, as stated above, that the costs incurred under the contracts in the instant case are currently deductible under Section 162.

A copy of this memorandum is being transmitted to our National Office for post review pursuant to our Manual Section (35)3(19)4. If our National Office makes any significant changes to our advice, we will notify you immediately.

Please feel free to contact Attorney Linda S. Bednarz at (215) 597-3442 if you have any further questions regarding this matter.

KENNETH J. RUBIN
Assistant District Counsel